At each juncture before the Commission and the Court, various parties, particularly the paging industry, have argued at length for the establishment of a "caller-pays" compensation system, and most of their arguments -- whether about the potential for fraud or the status of blocking capabilities -- are geared toward that objective. The Commission has already rejected the "caller pays" approach for dial-around calls and found that callers "should not be required to deposit coins when making calls otherwise billed to an account."[34] The Commission concluded that because transient callers value the convenience of making coinless calls from payphones, it would be burdensome to force transient callers to acquire and deposit coins to make subscriber 800 calls from payphones, especially when such callers have an expectation that coins are not necessary for these calls. Id.

The Commission found additional support for its conclusion in the 1996 congressional amendments to Section 228(c)(7) of the Communications Act of 1934 ("the

[34] Order on Reconsideration at para. 88. FCC policy has long fostered coinless calling, and the Commission has consistently rejected a "caller-pays" approach since 1983. When investigating how to apply access charges under divestiture, the Commission initially ordered LECs to recover interstate payphone costs through a per-call charge on customers placing interstate payphone calls (1+). MTS and WATS Market Structure, Third Report and Order, 93 FCC 2d 241, 280 ¶28 (1983). On reconsideration, however, the Commission replaced this approach with a mechanism that recovered the costs through the carrier common line charge, after concluding that end users could avoid this charge by using collect, third party billing, or credit card payment methods. MTS and WATS Market Structure, CC Docket 78-72, Memorandum Opinion and Order, 97 FCC 2d 682, 705, ¶58 (1983) ("Access Charge Reconsideration"), *aff'd in principal part,* National Ass'n of Regulatory Utility Comm'rs v. FCC, 737 F.2d 1095 (D.C. Cir. 1984), cert. denied, 469 U.S. 1227 (1985), *modified on further recon.*, 101 FCC 2d 1222 (1985), *recon. denied*, 102 FCC 2d 849 (1985). The Commission concluded that assessing a "coin deposit" surcharge on the end users was not in the public interest. Access Charge Reconsideration, 97 FCC 2d at 705, ¶58.

Act"), which prohibit carriers from assessing the calling party a charge for completing ***any*** 800 number. 47 U.S.C. §228(c)(7). (emphasis added). Although the Commission found that Section 228(c)(7) does not expressly apply to PSPs, that section "provides persuasive evidence that Congress intended to ensure that access to 800 number subscribers without the calling party incurring a charge." Order on Reconsideration at para. 89.

The Commission's carrier-pays approach was subsequently upheld by the U.S. Court of Appeals for the District of Columbia Circuit:

> Nevertheless, the Commission elected to adopt a "carrier pays" system in order to maintain the convenience of coinless calling upon which the public has come to rely. The Commission's balancing of the competing concerns of administrative efficiency and consumer convenience was not arbitrary.[35]

For all of their arguments about "locational monopolies" and "monopoly profits" it is hard to believe that the IXCs actually favor a caller-pays approach. Although APCC does not believe that the IXCs "monopoly" arguments have any validity, it is ironic that the IXCs have no concern at all about callers paying "monopoly" payphone rates as long as the IXCs are not directly involved in remitting the compensation. Making the caller deposit coins for a local call does nothing to eliminate the IXCs' concerns about "monopolies." AT&T argues that "[i]n a calling party pays system, the market dynamics of the coinless calling market segment exactly mirrors those of the local calling market segment. AT&T at 13 (emphasis added). If the two market segments "exactly mirror" each other, this is true whether or not the caller pays for the call by depositing coins or through a surcharge. If the two calls – local coin calls and subscriber 800 calls – have markets that mirror each other so precisely, it must be because the costs for each converges with the other, so that the rate for one call is appropriate for the other. This is precisely why APCC contends that an acceptable market-based compensation approach is one that relies on the local coin rate, although other market proxies, such as 0+ commissions and 0- transfer rates, would be superior to the local coin rate. Thus, the Commission has already achieved the goal of a market-based compensation approach with all of its benefits, without the necessity of switching to a caller-pays compensation system.

The Commission should stay the course in its rejection of a caller-pays approach. Requiring a coin deposit for caller-pays does not make sense. The basic concept behind a subscriber 800 number[36] is simple: it enables customers, family members, patients, and others to contact the 800 number subscriber from any location, at any time, free of immediate charge to the caller, with little burden on the caller. Individuals or entities who utilize the subscriber 800 option are content to pay for this convenient access to them, or else they would subscribe to a traditional, non-toll-free number. Shifting the payment for the call from the caller to the called party is the essence of subscriber 800 service.

Apart from these policy reasons for maintaining "toll-free" coinless calling, a caller-pays approach risks running afoul of TOCSIA, whether or not it expressly includes carrier access numbers. Sections 226(c)(1)(C) and (e)(2) restrict advance payment (i.e., a

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35 Payphone I at 567.

36 By using the term "800 number" throughout these comments, APCC intends to refer to all toll-free-to-the-caller numbers.

coin deposit) by a caller for access to non-presubscribed carriers at payphones.[37] Therefore, to the extent that *any* carrier would provide access through an 800 number, PSPs would be violating the law in originating those particular access calls from payphones. The possibility of such inadvertent, unintentional violations of a federal statute is of grave concern to PSPs, particularly since PSPs often have no way of knowing if the 800 number is a carrier access number.

One commenter, AirTouch Paging ("AirTouch"), urges adoption of a partial caller-pays mechanism. See AirTouch at 5-6. Unfortunately, AirTouch's proposal that the Commission create dedicated 8xx numbers for toll-free calls, which echoes its separate petition to the Commission earlier this year, will result in customer confusion and inconvenience, which will in turn have the effect of discouraging payphone use. Should the Commission elect to address it at all, this proposal should be considered only in an independent proceeding apart from the Commission's focus on responding to the issues within the scope of the Payphone II remand.

In its arguments favoring a caller-pays approach, PCIA contends that "targeted call blocking, as originally envisioned by the Commission, remains largely

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[37] 47 U.S.C. Section 226(c)(1)(C); 47 C.F.R. Section 226(e)(2). Section 226(c)(1)(C) states that "[e]ach aggregator . . . shall . . . ensure that no charge by the aggregator to the consumer for using "800" or "950" access code number, or any other access code number, is greater than the amount the aggregator charges for calls placed using the presubscribed provider of operator services." Section 226(e)(2) states that "[t]he Commission shall consider the need to prescribe compensation (other than advance payment by consumers) for owners of competitive public pay telephones for calls routed to providers of operator services that are other than the presubscribed provider of operator services for such telephones . . ." Id.

unavailable." PCIA at 4. CBC argues that call blocking does not protect subscriber 800 customers from having to pay unreasonable compensation rates, because blocking cannot be exercised on a per-phone basis. CBC at 6. In addition, CBC contends that even if call blocking were available in this manner, most subscriber 800 customers would not choose to block because they rely on being accessible from *all* phones. Id. (emphasis added).

As APCC has previously pointed out, however, the information necessary to block calls is available. This information, such as the line number of the payphone, will reside in the IXC's database, so that whenever a payphone with an unwanted price originates calls to a particular IXC's network, those calls will be blocked. Further, even if the requisite database for blocking purposes has not yet been created, there is no necessity to generate it until such time as per-call compensation is tied to individual PSP's prices. This will not happen until the second year of per-call compensation beginning October 1999. As a result, IXCs have an additional year to deploy any database deemed necessary.

B. Per-Increment Rates

One commenter, SkyTel, contends that the Commission should consider the length of calls in deriving a per-call compensation rate. SkyTel at 3-4. SkyTel contends that the compensation rate must create a "measured" per-call compensation rate that accounts for variations in call lengths. Id.[38] Proposals that the Commission consider per-

[38] APCC, in earlier comments, pointed out that there is a wide disparity in paging providers' estimates of the average length of a paging service call. Such a disparity illustrates perfectly the need for the Commission to defer consideration of these issues, if they warrant any consideration at all, to a separate proceeding where the differences in record data and contentions could be developed and addressed at length. APCC January 7, 1998 Comments at 38, n. 41.

increment pricing, however, are not new. The Commission's 1991 discussion in a notice of proposed rulemaking about such pricing,[39] which it ultimately rejected as unworkable in its 1992 TOCSIA Compensation Order, concerned compensation for some dial-around calls in a per-minute basis, not the per-tenth-of-minute pricing advocated by the paging industry and 800 subscribers. Given the several years that it took the industry to move to a per-call compensation system, which was ultimately mandated by statute, there is no reason to believe that a compensation system that is based on a handful of seconds of usage would be technically and administratively possible to achieve in the near future. Should such a per-increment compensation system be practicable in the future, without jeopardizing the compensation flows to which PSPs have long been entitled, the Commission will have the discretion to open a new proceeding to explore such possibilities.

C. Potential for Fraud

The Allen Lund Company ("Allen Lund") argues that the Commission's current per-call compensation system for subscriber 800 calls, which permits IXCs to pass through charges associated with per-call compensation, leaves it susceptible to and defenseless against unwanted payphone calls and extremely vulnerable to fraud and abuse. To "eliminate fraud and protect the innocent 800 subscribers," Allen Lund urges the Commission to reexamine its carrier compensation scheme and implement either a caller

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[39] Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation, CC Docket No. 91-35, Report and Order and Further Notice of Proposed Rulemaking, 6 FCC Rcd 4736, 4747 (1991).

pays system, or a system under which the compensation rate is shared among the carrier, the 800 subscriber and the PSP. Allen Lund at 2.

It is axiomatic, of course, that any compensation system has within it the potential for fraud. APCC has long maintained that the authorities must keep a vigilant eye on those situations were there is a potential for fraud. With assistance from both service providers and their customers, the authorities can detect, and quickly address, actual fraud through suspicious, irregular calling and billing patterns. APCC believes that any such fraudulent conduct must be prosecuted to the fullest extent of the law. In the meantime, however, the specter of potential fraud should not be used to undercut the fair compensation that is necessary to ensure the widespread deployment of payphones for the benefit of all people.

D. Other

Other commenters seek to have some 800 subscribers exempted from payphone compensation obligations or have non-profit activities considered in setting a compensation rate. Citicorp Services, Inc. ("Citicorp") contends that the Commission must consider the unforeseen impact the per-call compensation system for "toll-free" calls is having on not-for-profit activities, government services, and state government welfare, benefit and entitlement programs. Citicorp at 1. Citicorp further contends the Commission must draw a distinction between toll free calls made for commercial purposes and those made for non-commercial purposes, such as those to Electronic Benefit Transfer ("EBT") programs. Citicorp at 3. Citicorp argues that the Commission should reconsider the application of a per-call compensation surcharge to EBT programs, or in the alternative, consider the role of EBT programs in setting a compensation rate. Citicorp at 3, 6. Similarly, the Rhode Island Department of Human Services ("Rhode Island") urges the Commission to reconsider its "unfettered" deregulation of payphone service rates to prevent cost increases in providing EBT programs. Rhode Island at 2.

PSPs share the concerns about those who rely on EBT programs as well as society's less fortunate. However, as APCC has stated in the past, all of these people would be worse off if there were no payphones for them to use. It may be that there will be a day when the IXCs, as well as their 800 subscribers, agree to provide free or discounted services to non-profit groups. At that point, PSPs would be happy to join in and do their part as well.

Respectfully submitted,

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Dated: July 27, 1998

Exhibit 1

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Reply Declaration of John Haring and Jeffrey H. Rohlfs

July 27, 1998

I. Introduction

In its *Comments*, MCI has proposed a method for reckoning payphone compensation that suffers from precisely the disabilities of which we warned the Commission in our filing for APCC.[1] MCI proposes that the Commission calculate an *average* cost per call excluding what its own economists concede are genuine costs of production. ("Of course, site rents *are* a cost to the payphone operators" — emphasis in original.)[2] While the material MCI has assembled to document its measures (mis-measures, as it turns out)[3] of station costs discloses a great deal of variation in available station features and functionalities and related costs, MCI nevertheless proceeds to calculate a simple *average* for two types of stations with average characteristics (based on MCI's estimates of their prevalence in the marketplace) and then divides by an *average* number of calls to calculate estimates of costs per call.

As we have noted, this approach simply does not recover costs of above-average-quality and below-average-usage stations. Removal of such stations will lower average quality and raise average usage, implying still lower costs per call. Successive application of MCI's proposed approach can

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1 *See* Declaration of John Haring and Jeffrey H. Rohlfs, *APCC Comments*, July 13, 1998.

2 *See* E GROUP, *A Study of Payphone Market Organization and Compensation* (July 13, 1998), p. 13.

3 MCI would improperly exclude non-traffic-sensitive (NTS) costs of the coin mechanism from the joint costs of a payphone capable of supplying *both* coin and coinless calls to be recovered through proportional mark-ups over marginal traffic-sensitive (TS) costs. MCI would, in effect, like to eat its cake and still have it — sharing the economies of scope that derive from joint supply but not sharing the responsibility for cost recovery of the full costs of the machine that permits joint supply. In economic terms. MCI is simply seeking a free-ride.

thus be counted upon to reduce the number of payphone stations and the quality of the services they afford with adverse consequences for the consuming public. Neither MCI nor its economists address these discomfiting implications of their proposed approach; nor, in truth, can they since they are a fundamental flaw that inheres in the basic design of their proposed compensation scheme. It is not a matter of coming up with a fix or jiggering the assumptions. If the Commission wishes to avoid the outcomes, it needs to adopt a different approach for setting compensation that permits variations to reflect differences in operating circumstances.[4]

Why would the Commission want to adopt a method for setting compensation that produces these adverse consequences for performance? According to MCI, it has no alternative since, while the payphone business is itself competitive,[5] every payphone location is a market unto itself with pricing discretion limited *only* by callers' willingness to forego calling altogether—"an agglomeration of *thousands* of 'small' franchise monopolies."[6] This contention is, in turn, allegedly "demonstrated" in an attached economic analysis of the payphone market prepared by the E GROUP.

We have reviewed the E GROUP's analysis. It fails to demonstrate the existence of a significant "locational monopoly" problem. Its conclusions rest on introspection of dubious validity

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[4] MCI's economists claim that "the practical necessity of implementing a nationwide standard" argue for investigation of cost-based pricing rules (*See op. cit.*, p. 20). Precisely the reverse is the case: Practical necessity makes it *impossible* to implement cost-based pricing through administrative means (*i.e.*, development of "bottom-up" cost estimates) if account is to be taken of all economically relevant differences in station costs and calling patterns. Failure to take account of relevant differences will predictably result in service degradations. While asserting their belief that opportunity costs may be reasonably assumed to be zero, the E GROUP remarks that, if the physical space required for the payphone has an opportunity cost, then that cost is an economic cost and should be included in the calculation of recoverable costs (*op. cit.*, p. 14). Cost-based pricing would thus entail assessment of the existence and magnitude of opportunity costs at thousands of payphone station sites. Failure to recover non-zero opportunity costs will predictably result in service degradation. In contrast, the Commission's "market-based" approach to compensation permits variations which will sustain feature-rich equipment and low-usage (but, nevertheless, economically and socially valuable) sites. This approach exploits the market's ability to set reasonable prices and then makes suitable adjustments to reflect differences in marginal TS costs of different types of calls.

[5] MCI's cost documentation amply illustrates the ready availability and modest costs of the equipment and other inputs needed to enter the business. Moreover, there is apparently an active market in used equipment suggesting limited needs to sink investments. According to the E GROUP (*op. cit.*, p. 12), "Cost differences between phones will arise primarily from locational rents." The E GROUP, however, presents no empirical evidence regarding variations in the magnitude of such rents and, as noted in fn.4 *supra*, concedes that the opportunity costs of site locations constitute a recoverable cost. In MCI's *Payphone Cost Study*, prices used to estimate payphone station investments ranged from $549 to $1,581 for smart phones and $149 to $560 for semi-smart phones. There is also considerable variation in investments for pedestal, enclosure and mounting equipment.

[6] E GROUP, *op. cit.*, p. 12, emphasis added.

and an econometric study so flawed in conception and execution as to fail to provide any valid basis for policymaking. In at least one significant instance, a principal policy prescription appears to have been interpolated into the study with no supporting argumentation.

II. Too Far To Walk

In our earlier filing, we noted the importance of appropriate model selection for good economic analysis and policy prescription.[7] In their study, the E GROUP attempts to apply the economic model of franchise monopoly to individual payphone stations. On this view, individual payphone stations (or gas stations or fast-food restaurants) have the same economic character as the cable television monopoly franchise within a particular locality.[8] Thus, while Ma & Pa's may only be a little market on the corner, it is the only market on the corner and, therefore, it has a corner on the market.

The E GROUP readily concedes that there may well be a grocer or payphone or service station across the street (*viz.*, on one of the *other* corners), but their view is that "it hardly seems reasonable" to expect a consumer to cross the street for a price difference of a few cents or a dime. What may not seem reasonable in the groves of academe may well make a lot of sense to most other people. They will alter their behavior to avoid paying high prices and to take advantage of more economic alternatives.[9] Persons who feel advantage has taken of them in a particular circumstance are quite likely to alter their future behavior to prevent it from happening again.[10] Indeed, it is precisely the fear of losing (repeat) business that serves as a powerful economic incentive for service providers to offer good value for money. Trying to gouge consumers is, in general, highly unlikely to constitute a strategy for business success.

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[7] *Op. cit.*, p. 7.

[8] One obvious difference between these different types of enterprises is the number of firms that can operate within a given locality.

[9] Economizing behavior is normally the rule for persons with lower incomes or persons with *low* incomes who need to economize on their purchases of necessities such as food or gasoline and who rely on payphones for access to the public telephone network, or to persons whose opportunity cost of time is lower (*e.g.*, retired persons) or whose marginal utility of income is higher.

[10] The expression "fool me once, shame on you; fool me twice, shame on me" motivates many individuals' behavior.

For many individuals, crossing the street to save a dime is eminently reasonable. Indeed, for many it is a matter of principle. It is precisely the reason service stations in locational proximity to one another generally charge the same price for a gallon of gasoline. If a station on one corner charged a penny less, people might save a dime on a fill-up, some would avail themselves of the opportunity and that prospect leads the competitive process to establish a same-price market equilibrium for all the stations at (or near) an intersection.

While application of the Merger-Guideline approach to market definition easily leads to the conclusion that the cable television service offering in Fairfax County does not compete with the service offering in Montgomery County (because a small change in price will not induce consumers in one county to shift to purchase of the cable offering available only in the other county), it does not typically lead to the conclusion that, say, gas stations operating in different locations within a locality do not compete with one another. Market definition entails identification of significant "chinks in the chain of substitutes." Gas (or payphone) stations on different sides of town (call them A and G) may share no actual or potential customers in common, but they are still usually and appropriately regarded as competing in the same economic market because they are linked by a chain of substitution that connects A to B and B to C and, eventually, F to G. Many of the stations are differentiated by location, but they are sufficiently linked by actual or potential substitution opportunities, so that they are properly regarded in economic terms as competing with one another. The economic model that most accurately describes the payphone market is thus one of differentiated competition rather than franchise monopoly.

III. Substitution Opportunities

The E GROUP's analysis of substitution opportunities on both the demand and supply sides is hard to credit seriously. Consider their statement (on p. 18):

> With the monopoly structure, payphone customers' demands reflect *zero competition* from *nearby competing* phones, and their elasticities of demand arise *solely* from substitution between payphone services and *other* goods (emphasis added).

If a "nearby" phone is "competing," its competition is, by definition, reflected in customers' demands and cannot be "zero." If a phone is "nearby," how can it reasonably be judged not to be competing with a non-zero effect? The E GROUP apparently would have the Commission believe that two phones can be in close physical proximity to one another, charge significantly different prices for the same service and there will not be any customer migration from the high to the low-priced alternative. In reality, many consumers alter their consumption behavior specifically to avoid high-priced alternatives (all need not do so for pricing to be competitively constrained) and it strains credulity to believe that no substitution will occur in this circumstance.[11] The E GROUP's view is that the only source of demand elasticity is willingness to forego making a particular call. This is an extremely circumscribed view of normal consumption behavior. Confronted with a high charge and a pressing need to communicate, some callers may well proceed with a call, but that experience will likely condition their future behavior, prompting them to seek more reasonably priced alternatives and to avail themselves of substitute means of calling. A reputation for high prices without commensurate quality will discourage consumption and risk loss of repeat business.

While claiming that elasticities of demand solely reflect substitution against other goods, the E GROUP concedes that "subscription to a cellular service probably does reduce the subscribed consumer's use of payphones" and that an antitrust analysis might recognize the substitutability of the two services. The fact that they are substitutable and are, given differences in prices and availability, often substituted[12] implies that demand for payphone service will become more elastic as wireless service becomes more economic and widespread.[13]

The E GROUP's analysis of supply is similarly crimped. They assert (at p. 13) that: "Free entry into the payphone industry *only* increases competition by providers for good sites — it does

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[11] In this regard, we note that the E GROUP fails to give any consideration to possibilities for temporal substitution (*e.g.*, placing calls on a wireline phone before leaving or after arriving) or for strategic decisions to take steps to avoid high-priced alternatives and to place oneself in a position to exploit economic alternatives. This might, for example, entail altering the route one takes in walking from the subway to the office or on the commute home, or deciding to place a call from one location rather than another.

[12] A wireless phone affords a convenient, usually higher-priced calling option that might be exercised when a payphone is not available or available but at a high cost. The fact that an individual purchases a wireless phone does not mean that they will use it for all their calling needs. Purchase of an expensive automobile does not imply that a person will use it for all their transportation needs. For some purposes, they may substitute a minivan (for example, *e.g.*, transporting children); for others, they may select a mass-transit alternative.

[13] The E GROUP's reference (at p. 9) to "high costs of cellular service and low penetration" is simply misinformed. Wireless rates are falling precipitously and penetration is, as we noted in our earlier Declaration (*op. cit.*, p. 6, fn. 7), already substantial and rapidly rising.

not create more good sites" and (at p. 15) that "Increased entry by payphone providers *does not* increase the number of good sites for payphones" (emphasis in original).[14] Entrants into the payphone business will be surprised to learn this since a fair portion of the phones they have installed are located in newly developed locations. One major factor in the success of new entrants has been their business acumen in identifying and developing successful new sites. Moreover, note that, were the E GROUP's assertion correct, it would imply a very substantial increase in competition *at existing sites* during the competitive era in payphone telephony. Since competitive entry has been permitted into the payphone industry, the number of pay stations deployed has grown by about 30 percent with the addition of some 300 thousand new phones.[15] The E GROUP cannot have it both ways — 300 thousand new phones imply either that competition *at* good sites has increased markedly or that a substantial number of new sites has been developed. Alternatively and as is in reality the case, both competition *and* the number of new sites have increased and the E GROUP is wrong on both counts.

The E GROUP presents no evidence that site supply is fixed or constrained; to the contrary, their view is apparently that space is available at zero cost.[16] They offer no explanation for why profit-seeking behavior would not or could not effectively replicate an economically profitable operation. The constraints that prevent expansion of supply in other than the most narrowly defined "locations" are never described by the E GROUP. The E GROUP's unsustainable view is that, unless every fast-food restaurant, every service station and every payphone site location offers several different brands, there is a competitive market failure.

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14 Competition for input supplies is, of course, generally regarded as salutary ensuring efficient allocation of resources. Its absence (as in, say, the acquisition of program services by monopoly multichannel video program distributors, *viz.*, cable) has been a source of concern on the Commission's part. *All* scarce resources are ones for which competing demands exceed supply at a zero price. The fact that multiple parties seek use of a particular resource implies nothing about monopoly or market power other than its absence on the demand side.

15 *See* Strategic Policy Research, *Economic Report on Resolution of Payphone Regulatory Issues* (July 1, 1996, pp. 14-20), submitted on behalf of BellSouth.

16 *See, op. cit.,* fn. 28, p. 14.

In reality, the sites where payphone stations might be located to significant competitive effect are usually quite extensive.[17] As with other relevant inputs in this industry, so with site locations — there are, in general, no meaningful barriers to expansion of output. If a particular site location proves valuable, there will be incentives for allocation of nearby space by potential site suppliers and effective substitutes will be developed. If supernormal profits can be anticipated in a particular area, the economically reasonable expectation is that additional pay stations will be installed within the area or nearby.[18]

The E GROUP's analysis (at pp. 4-5) confuses the offering of exclusivity in the use of a property or right with conveyance of monopoly power.[19] According to the E GROUP (p. 4), the highest bid at competitive auction for an exclusive right to use a property "will equal the monopoly profit." This is an error in economic analysis. It implies, on the one hand, that exclusivity conveys monopoly power. Our firm has the exclusive right to use our office space; but in acquiring the space we, most assuredly, did not acquire monopoly power. It implies, on the other hand, that in the absence of prospective monopoly profit, the highest bid will be zero. As long as demand exceeds supply at a zero price, the highest bid will be greater than zero and reflect the existence of scarcity rents or rents reflecting differential productivity. Contradicting itself, The E GROUP subsequently states (at p.14) that in calculating recoverable costs, "the opportunity cost of the physical space on which the payphone is located should be added if it is above zero." If scarcity rents are part of recoverable costs, how can winning bid values fail to reflect them?

The fact that a landlord offers an exclusive use right does not, in itself, convey any information of relevance to the question of monopoly, any more than the fact that a program syndicator's offering an exclusive performance right implies creation of monopoly power. If a

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[17] As we noted in our earlier Declaration, it is certainly possible to conceive of special circumstances where supply alternatives may be limited (*e.g.*, a mass transit facility), but these are the exception rather than the rule. As we noted and the Olympic Village example cited by the E GROUP (*op. cit.*, p. 13, fn. 26) illustrates, consumer complaints can usually be relied upon to police unreasonable rates.

[18] This expectation is particularly justified in the absence of any plausible explanation for the assumption that payphone sites are in fixed supply other than the trivial sense in which the laws of physics prevent two phones from simultaneously occupying precisely the same physical space.

[19] Thus, acquisition of the exclusive right to broadcast Seinfeld reruns in a particular market does not convey market power in the supply of audience exposures.

particular location or program is likely to prove particularly productive in comparison with others, it will presumably earn rents determined by the valuation and cost of marginal output. Far from representing fruits of monopoly, such payments reflect the operation of competitive processes that set prices at the margins of production and consumption. To thwart such processes, arguing (as the E GROUP does at pp. 17-18) that compensation should be suppressed to prevent unjust enrichment, simply consigns the public to reduced output at the margin along different dimensions of output.[20] Replication of the failed energy policies of the 1970s in the payphone context, will produce the same sorry consequences.

The E GROUP thinks an assumption of zero opportunity cost of space is reasonable. We disagree. In our view, remuneration for space rentals, in general, primarily reflects the value of foregone opportunities. Such opportunities take the form of other revenue-producing uses (*viz.*, vending machines, additional seating, shelf space, *etc.*) as well as the benefits of vacant space. In weighing decisions about space allocation, proprietors will usually need to weigh a variety of economic and technical tradeoffs. Are the revenues from one use sufficient to offset the sacrifice of foregone revenues or sales from another? How does a particular use affect demand for other products?

The E GROUP's simplistic view is that space owners exclusively seek to maximize profits from payphone installations through monopoly exploitation. This is questionable at best and strikes as a highly unlikely business strategy in most circumstances. The proprietor of a convenience store or a restaurant is far more likely to lose money through this strategy than make it. The E GROUP's views notwithstanding, few calls will be made on phones with exorbitant rates, but business establishments with such phones run the risk of acquiring a reputation for uneconomic value and suffering losses of business on this account. The notion that a restaurant would be willing to sacrifice lost profits on meals for extra profits from a payphone station or that a convenience store would sacrifice profits on sales of groceries and food is hard to believe. More likely is that a business person will regard a payphone station as a small part of a larger, more complex business equation.

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[20] This may be a matter of little import to Worldcom/MCI which chooses to focus its business on big-ticket customers and locations and to ignore marginal customers and locations. Protection of the interests of the latter is presumably an appropriate focus of government policy.

In a restaurant or an outdoor setting, vacant space is often aesthetically pleasing and contributes to a feeling of spaciousness and an attractive ambience.[21] A payphone installation may entail a sacrifice of aesthetic values and loss of utility and revenue associated therewith. Charges for space rentals compensate for these costs/sacrifices of other valued resource uses. When site locations are scarce because they have alternative uses (including vacancy) and opportunity costs (sacrifice of revenues and amenity values), failure to provide adequate compensation to cover such costs means that space will not be allocated for use in particular employments with an associated attenuation of supply.[22]

IV. Econometric Analysis

The E GROUP has also produced an econometric analysis which purports to evaluate (*inter alia*) the effects of prices and deregulation on the supply of payphones.[23] The study is flawed in a variety of aspects and does not afford a sound basis for valid inferences relevant for policymaking. In particular:

1. *The variables are mismatched.* The dependent variable is *change* in number of payphones, while an absolute variable (not a change) is used for price. We cannot think of any reasonable and general economic model that leads to this unusual specification of the supply function. If supply responds rapidly to price, quantity (not change in quantity) can reasonably be modeled as a function of price. If supply is originally in equilibrium, change in quantity can reasonably be modeled as a function of change in price. If supply adjusts slowly and is originally in disequilibrium,

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[21] Use of a payphone in a restaurant or similar establishment may disturb other customers. The proprietor must thus weigh any adverse revenue consequences against any beneficial ones. In this regard, it strikes as highly unlikely that a restaurant or other retail business establishment will find it worth the risk of alienating its clientale by supplying unreasonably priced payphone service. What is more likely (and apparently now occuring in many regions) is that retail establishments will seek competitive advantage by supplying and advertising reasonably priced service offerings.

[22] The fact that a good is scarce does not, of course, imply that its supply is fixed or that it is in short supply; scarcity implies the existence of competing uses.

[23] *See op. cit.*, pp. 20-22.

quantity will depend on both price *and* change in price.[24] In all these cases, the E-Group's methodology will not estimate the correct supply response. Their model is poorly specified and constitutionally incapable of supporting any economically coherent inferences about supply elasticities.

2. *The model confounds supply and demand effects.* The E GROUP estimates an equation and simply asserts that the equation reflects the effect of price on the supply of payphones. One may well ask why the same equation could not equally reflect the effect of price on payphone *demand.* The answer is that it could! Indeed, the variables included in the equation (*e.g.*, the population density, the monthly line rate for residential service, and the percent of poor families) would all be included in a demand function. On the other hand, variables that affect supply but not demand — *viz.*, costs — do not appear in the equation. Consequently, there may more basis for interpreting the equation as a demand function than as a supply function. Certainly, one cannot draw any inferences about the *supply* elasticity from this estimation exercise.[25]

3. *The model is not properly scaled.* The model postulates that an equal *percentage* change in price would lead to the same *absolute* change in payphones in all states. In reality, one would expect that the magnitude of the effect would be greater in large states than in small states. Suppose, for example, that the price of payphones rose by 10 percent. One would expect that the absolute number of payphones added would be much greater in California than in Nevada. The E GROUP model, however, implies equal absolute charges in the two states. This model result is simply implausible.

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[24] Conceivably, price changes from earlier years might also affect supply under these circumstances. Alternatively, quantity could be modeled as depending on price and lagged quantity (Koyck lag) to reflect disequilibrium adjustments.

[25] It is also possible that the E GROUP has estimated some linear combination of supply and demand. Econometric techniques for estimating supply (rather than a combination of demand and supply) have been well-known for over forty years. (*See*, for example, T.W. Anderson and Herman Rubin, "Estimation of the Parameters of a Single Equation in a Complete System of Stochastic Equations," *An. Math. Statist.*, Vol. 20, pp. 46-63, 1949 and W.C. Hood and T.C. Koopmans (eds.), *Studies in Econometric Method*, Wiley, New York, 1953, Chapter 6.) Unfortunately, the E GROUP does use those techniques.

The E GROUP also draws improper inferences from their model in several other respects. One would expect that deregulation would affect supply primarily by affecting the price. Even if deregulation were very important, it might have little effect in the model estimated by the E GROUP. In that model, the estimated deregulation effect does not include the effect of deregulation on price. Finally, the main conclusion of the econometric analysis is that the coefficients of price and deregulation are statistically insignificant. This finding does not, in itself, establish that the elasticities are small. It proves only that the statistical model cannot estimate the effects very precisely. Given the fundamental problems with the model, that result is hardly surprising.

The E GROUP evidences little awareness of the institutional changes in the payphone industry that have occurred as a result of implementation of the Telecommunications Act's provisions regarding payphone service or, for that matter, of the historical regime under which payphone services were supplied. Historically, as the Commission is well aware, payphone service was supplied on a subsidized basis. Under relevant provisions of the Telecommunications Act of 1996, the payphone industry is now to operate on a *subsidy-free*, stand-alone basis.

The premise of the E GROUP econometric analysis is that observed price increases for payphone service should have elicited an increase in the number of payphones installed. But this premise is itself problematical. The adjustment of prices and the number and specific identity of pay stations to removal of the subsidies for payphone service does not necessarily imply or reflect any stimulus to entry.

V. Case of the Missing Support

At p. 14 of the E GROUP study, a series of conclusions is interpolated into the text. The E GROUP is at pains to insist that its "analysis will lead to these conclusions" and "explain the basis of these conclusions." We were quite interested to see what the E GROUP's rationalization of these conclusions would be since they are so completely at odds with standard economic analysis and the economic way of thinking.

The first conclusion is that "The minimum economic cost of a payphone capable of providing both dial around and coin calls should be calculated." Of course, the "minimum" cost will vary greatly (as MCI's documentation readily discloses) depending on the various features and functionalities embodied in the machine, so it by no means clear what "the minimum" means or how this instruction should be implemented. Nor is it clear what the implications of failure or success in carrying out this instruction are. If minimum quality is selected as the basis for compensation, then minimum quality is what will be supplied to the consuming public, notwithstanding any customer preferences for higher quality. Even minimum quality will prove unsustainable when compensation is on the basis of average usage and prospective usage at a particular site is below average.

The second conclusion is that "all costs attributable ("caused by") coin capability [*sic*], including costs of the coin equipment, coin collection, vandalism and/or theft prevention measure, and the like should be subtracted." Having gone to the trouble of calculating the minimum cost of payphone capable of providing "*both* dial around *and coin calls*," why one should then deduct the equipment (*i.e.*, NTS) cost of providing coin calls is not obvious. Indeed, economic analysis indicates that it is a mistake — if coinless calls are to benefit from the economies of scope that inhere in an instrument that is capable of handling both coin and coinless call, they should share responsibility for recovery of the costs of the instrument that affords these joint abilities. Alfred Kahn has presented penetrating and persuasive economic analysis on this point in his Declaration appended to the RBOC Coalition's *Comments*. The reader who seeks the E GROUP explanation of the basis for this conclusion will search in vain.

The third conclusion — that opportunity costs of physical space *should be* recovered — is correct. It does, however, *contradict* the E GROUP's earlier (erroneous) claim that competitive high bids for space rentals will (only) equal monopoly rents.

The fourth conclusion is that the competitive prices of coin calls and coinless calls should be calculated, and the average quantities of usage associated with these prices should be calculated. Besides being impossible, this instruction amounts to saying that the industry should be subjected to full regulation. The whole purpose of the Telecommunications Act of 1996 is to substitute competition for regulation to guide resource allocation in the telecommunications industry. This is a laudable objective given the manifold imperfections and disabilities of regulation. The purpose of competition is to determine competitive prices and efficient deployment of resources. If regulation were capable of duplicating the results of competition, we would not need competition. The FCC is, on its own (*i.e.*, without the aid of market-based results), not in a position to know how many payphones of what different types should be deployed to what specific locations and what prices should be charged. It is precisely the competitive process' ability to establish competitive rates and meet a diverse set of needs in a diverse set of operating circumstances that supplies the premise and accounts for the superiority of the Commission's market-based approach to compensation. Leaving aside the fundamental problems and performance incapacities with MCI's compensation scheme, the notion that the FCC can supply bottom-up cost estimates for a million and one-half stations spread across the country — *each of which MCI claims is a separate market* — is ludicrous on its face. The impossible cannot be an optimal policy since only feasible policies are potentially optimal.

The fifth conclusion is that joint and common costs should be allocated based on the estimated competitive quantities of these calls. This instruction flies in the face of economic analysis and is *anti*-economic. Moreover, it directly *conflicts* with Conclusion Four. In economic terms, as the Commission well understands, the problem is not how to *allocate* costs, but rather how to recover them efficiently. As we explained in our earlier Declaration (pp. 7-8), in a differentiated competitive or a perfectly contestable market equilibrium, operation of the competitive process results in prices set in inverse proportion to demand elasticities (*viz.*, in accordance with the Ramsey principle). If payphone prices are established in accordance with Conclusion Five, Conclusion Four *cannot be satisfied* because competitive prices would be established in accordance with the Ramsey principle rather than on the basis of a spurious and arbitrary cost allocation.

VI. Conclusions

The E GROUP misapplies the economic model of franchise monopoly to the payphone industry which is more accurately described in economic terms by a model of differentiated competition. The E GROUP's analysis is premised on implausible and extreme assumptions about consumers' [in]sensitivity to price differences and the fixity of good site location supplies. The methodology MCI and the E GROUP espouse is incapable of recovering relevant economic costs and is guaranteed to degrade service to the public. Moreover, as specified, this methodology is self-contradictory and incapable of being implemented. The Commission would be ill-advised to pursue this approach to setting compensation.

I hereby swear and affirm that the statements contained in the attached Reply Declaration are true and correct to the best of my knowledge and belief.

John Haring

County of Montgomery

State of Maryland

Subscribed and sworn before me this 27th day of July 1998.

Adrienne Wells Vendig

Notary Public

ADRIENNE WELLS VENDIG
NOTARY PUBLIC STATE OF MARYLAND

My commission expires: My Commission Expires September 28, 1998

I hereby swear and affirm that the statements contained in the attached Reply Declaration are true and correct to the best of my knowledge and belief.

Jeffrey H. Rohlfs

County of Montgomery

State of Maryland

Subscribed and sworn before me this 27th day of July 1998.

Adrienne Wells Vendig

Notary Public

ADRIENNE WELLS VENDIG
NOTARY PUBLIC STATE OF MARYLAND

My commission expires: My Commission Expires September 28, 1998

CERTIFICATE OF SERVICE

I, Valerie Furman, hereby certify that on July 27, 1998 a true and complete copy of the foregoing Reply Comments on the American Communications Council were sent by first claim mail, postage prepaid, or by hand-delivery (*), to the following parties:

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